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Governance infrastructure and indebtedness of African countries: Do regional blocs matter?

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ABSTRACT

Motivated by the intermediating role of good institutions in enabling growth via external debt financed investment and the touted promise of regional integration for Africa's growth prospect, we use data on 37 countries, over the period 2002–2010, to explore the governance institutions—external indebtedness nexus in Africa, at the regional bloc level. We find a robust negative relation between governance institutions and external indebtedness in East & Horn of Africa, Central Africa and Southern Africa; and unclear relationships in North and West Africa regions. Importantly, these baseline results are robust to the consideration of debt write-offs, natural resource rents, and endogeneity. Further, we find that geographic, economic and cultural factors of proximity, intra-regional activity, shared official language, legal origin and dominant religion, largely explain the commonality of Africa's regional blocs of countries. These and other results of the study can support potential external debt management strategy that leverages effective governance institutions and enhanced regional economic integration.

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1. Introduction

The Heavily Indebted Poor Countries (HIPC) initiative of 1996 is among several high profile programs put forward by multilateral development organizations in attempts to mitigate the ravages of

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external indebtedness in nation states, particular developing nations[1]. Among the 36 countries that have been granted some form of debt reduction, 30 of them are in Africa (IMF, 2014). Thus, in addition to concerns about ramifications of the recent global financial crisis of 2008, African countries had continued to grapple with external indebtedness problems. Further effort to tackle this scourge saw the African Development Fund (AfDF) join forces with initiators of HIPC, the World Bank and the IMF, to introduce in 2005 the Multilateral Debt Relief Initiative (MDRI) whose main thrust was to provide full debt relief to countries that complete the HIPC initiative process (IMF, 2014). Therefore, despite some recorded reversal of indebtedness trend in Africa attributable to the externally originated HIPC initiative, the MDRI and some recent empirical works (e.g., Asiedu, 2003; Chauvin & Kraay, 2005; Vamvakidis, 2007; Forslund, Lima, & Panizza, 2011; Muhanji & Ojah, 2011) point to the need to seek a more enduring approach that would not only mitigate the ravages of external indebtedness but also guide the productive use of external debt financing by African countries.

This paper is motivated along the lines of a search for such an approach. The guiding light for this search sensibly springs from asking the fundamental questions of: (i) What caused the level of unsustainable external indebtedness among African countries? (ii) And why are swaths of African countries apparently susceptible to this problem, with a seeming structural inability to manage well external debt finance?

Pattillo, Poirson, and Ricci (2001) posit that poor macroeconomic environment leads to investment projects that are poorly designed, badly resourced and poorly implemented; thus, lowering the contribution of capital accumulation to growth. This was largely the case for HIPCs whose poor policies and continued borrowing in the face of negative external conditions meant that investments, to the extent that they actually took place, did not contribute much to growth. Instead, their continued borrowing and poor export performance led to high stocks of accumulated debt that created uncertainty and debt overhang (Pattillo et al., 2001; Muhanji, 2011).

In addition to sound macroeconomic policies, effective governance institutions have been shown to have important effects on a country's ability to attract less volatile external capital, which minimizes the country's vulnerability to crises (Prasad, Rogoff, Wei, & Kose, 2003). Specifically, Prasad et al. (2003) posit that countries with good macroeconomic policies and good governance institutions (pull factors) are more growth-oriented due to their ability to attract foreign direct investment (FDI) than countries lacking FDI pull factors. In fact, transparency of government operations, which is one of the dimensions of good governance, has a strong positive impact on investment inflows from international mutual funds. Conversely, where governance institutions are sufficiently weak, the presence of financial integration can cause an exodus of domestic capital and, thus, lower the growth prospect of the economy.

Further, according to the *institutions hypothesis*, societies that possess good institutions are organized in a way that upholds the rule of law; encourages investment in machinery, in human capital, and in better technologies; facilitates broad-based participation in economic and political life by the citizens; and supports market transactions (Acemoglu, Johnson, & Robinson, 2002). The following critical features of good institutions pertain: first, enforcement of property rights for a broad cross-section of society, so that a variety of individuals have incentives to invest and take part in economic life; second, constraints on the actions of the elite, politicians and other powerful groups so that these people cannot expropriate the wealth of others in the society or create a highly uneven playing field; and finally, some degree of equal opportunity for broad segments of the society, so that they can make investments, especially in human capital, and participate in productive economic activities. Acemoglu et al. (2002) further argue that where the rule of law is selectively applied and property rights are non-existent for the vast majority of the population, the political and economic powers of the elite are without bounds, and only a small fraction of citizens have access to education, investment, and

[1] The HIPC initiative was launched jointly by the World Bank and the IMF, with the aim of ensuring that developing countries are not left, unaided, to face a debt burden they could not manage. A major reform conditionality of the initiative requires that prospective beneficiary countries develop a Poverty Reduction Strategy Paper (PRSP) through a broad-based national participatory process (Easterly, 2002; Asiedu, 2003; IMF, 2014). I.e., the initiative mandates the establishment of some form of institutional infrastructure.

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